FILE COPY

IN THE

Supreme Court of the United States

OCTOBER TERM—1942.

No. 61

IN THE MATTER

of

THE WESTERN PACIFIC RAILROAD COMPANY, a corporation,
Debtor.

IRVING TRUST COMPANY, as Substituted Trustee under the General and Refunding Mortgage of The Western Pacific Railroad Company,
Petitioner.

against

CROCKER FIRST NATIONAL BANK OF SAN FRANCISCO and SAMUEL ARMSTRONG, as Trustees under The Western Pacific Railroad Company First Mortgage dated June 26, 1916, et al.,
Respondents.

BRIEF OF PETITIONER, IRVING TRUST COMPANY, AS REFUNDING MORTGAGE TRUSTEE.

H. C. McCOLLOM,
Attorney for Petitioner,
IRVING TRUST COMPANY,
As Trustee under
Debtor's Refunding Mortgage.

ORRIN G. JUDD,
Of Counsel.

Dated: September 14, 1942.

INDEX

CASES CITED

STATUTES CITED

IN THE

Supreme Court of the United States

OCTOBER TERM 1942

No. 61

IN THE MATTER

of

THE WESTERN PACIFIC RAILROAD COMPANY, a corporation,

Debtor.

IRVING TRUST COMPANY, as Substituted Trustee under the General and Refunding Mortgage of The Western Pacific Railroad Company,

Petitioner,

against

CROCKER FIRST NATIONAL BANK OF SAN FRANCISCO and SAMUEL ARMSTRONG, as Trustees under The Western Pacific Railroad Company First Mortgage dated June 26, 1916, et al.,

Respondents.

BRIEF OF PETITIONER, IRVING TRUST COMPANY, AS REFUNDING MORTGAGE TRUSTEE

This case is before this Court on writ of certiorari granted April 27, 1942, directed to the United States Circuit Court of Appeals for the Ninth Circuit, to review the decree of said Circuit Court of Appeals rendered November 28, 1941 (R. 2675), as amended by decree on rehearing rendered

February 16, 1942 (R. 2681), which decree reversed an order of the United States District Court for the Northern District of California entered August 15, 1940 (R. 1569) approving a plan of reorganization for the Debtor under Section 77 of the Bankruptcy Act.

Opinions below

The opinion of the District Court, dated August 15, 1940 (R. 1569), is reported in 34 F. Supp. 493.

The opinion of the Circuit Court of Appeals, dated November 28, 1941 (R. 2663), is reported in 124 F. (2d) 136. No opinion was rendered on rehearing.

Jurisdiction

The jurisdiction of the Court is invoked under Section 240-a of the Judicial Code, as amended by Act of Congress of February 13, 1925 (U. S. Code, Title 28, Section 347-a).

Statement of the case

The decree under review was entered in a proceeding for reorganization of the Debtor, a railroad company, pursuant to Section 77 of the Bankruptcy Act.

Petitioner, Irving Trust Company, is Trustee under the Debtor's General and Refunding Mortgage dated as of January 1, 1932, having been substituted as such Trustee on November 13, 1936 (R. 1053) during the course of hearings before the Interstate Commerce Commission on various proposed plans of reorganization. (Such mortgage is hereinafter called the "Refunding Mortgage", and petitioner is hereinafter called the "Refunding Mortgage Trustee".)

This petition relates to the relative liens of the Refunding Mortgage and the First Mortgage of the Debtor upon

very important properties—the extent of their relative liens being essential in determining the proper allocation of new securities to be issued under the reorganization plan.

The lien questions were not passed on by the Circuit Court of Appeals, although they were presented by the Refunding Mortgage Trustee's appeal. The review on this petition therefore relates both to the question whether the Circuit Court of Appeals erred in failing to decide the lien questions, and to the question whether the District Court erred in respect of the merits of the lien questions.

Bonds outstanding under the Refunding Mortgage aggregate $18,999,500 principal amount (R. 1053), and all of them are pledged, in varying amounts, with three creditors of the Debtor, namely, A. C. James Company, Railroad Credit Corporation, and Reconstruction Finance Corporation.

The Refunding Mortgage is a lien on substantially all the property of the Debtor (R. 1231-46).[1] The lien of the Refunding Mortgage is subject "in so far, *but only in so far*[2] (in extent, degree of priority or otherwise), as in law the same respectively may attach" (R. 1245) to the First Mortgage of the Debtor dated June 26, 1916, under which there are outstanding approximately $50,000,000 principal amount of bonds (R. 1047).

The Reorganization Plan

Evidence respecting the relative liens of the two mortgages on various parcels of property was introduced before the Interstate Commerce Commission. This evidence gave

---

[1] The granting clauses of the Refunding Mortgage are printed in the record at the pages indicated. The balance of the Mortgage (I. C. C. Ex. 6) is not printed, but constitutes part of the record, which may be referred to, by stipulation (R. 2612-25).

[2] Italics throughout the brief are supplied by counsel, unless otherwise indicated.

rise to legal issues, which had not been presented to the court for decision before the Commission hearings, the present Refunding Mortgage Trustee not having been appointed until after the proceedings in the Commission were under way.

The Commission made a preliminary decision of the legal issues presented by such evidence, although stating that "final adjudication of this and similar questions must be made by the court" (R. 262). Its original report overruled all the Refunding Mortgage Trustee's contentions and stated that the First Mortgage bondholders should be "considered as having a first lien upon practically all the assets of the Debtor" (R. 267). In consequence, such Report provided for the issuance of nothing but common stock to the creditors secured by Refunding Mortgage bonds (R. 278)—except as the R. F. C. was offered special treatment, on a parity with First Mortgage Bondholders, in consideration of its purchase of new bonds of the reorganized company.

Following a petition for modification filed by the Refunding Mortgage Trustee, the Commission, in a supplemental report, recognized that cash deposited with the Refunding Mortgage Trustee, and certain securities of Tidewater Southern Railway Company (a subsidiary of the Debtor) which were admittedly subject to the Refunding Mortgage as a first lien, had substantial value, and directed that the holders of Refunding Mortgage bonds be awarded, in consideration thereof, new income mortgage bonds in the amount of $732,010 and new participating preferred stock of a par value of $1,147,955 (R. 315).

Under the Plan as so modified, the three pledgees of Refunding Mortgage bonds would thus receive, in addition to cor mon stock, varying amounts of such new income mortgage bonds and new participating preferred stock, the allocation of such new securities being made in proportion to the amount of Refunding Mortgage bonds which each creditor holds in pledge (R. 315),—subject to the aforesaid special provisions for the R. F. C. in consideration of its purchase of new bonds (R. 312, 316).

The total principal amount of debts secured by Refunding Mortgage bonds aggregates $10,257,580.76 (R. 1953-57), so that the new income mortgage bonds awarded by the Commission amount to approximately 7% of the principal debt, and the new participating preferred stock to approximately 11% of such debt; these ratios are still far below those allotted to First Mortgage bondholders, namely 40% of the principal of their debt in new income mortgage bonds and 60% of such debt in new participating preferred stock (R. 390-91).

The Refunding Mortgage Trustee is not concerned with the distribution of the new income mortgage bonds and participating preferred stock as between the three Refunding Mortgage creditors, but only with its claim that the Refunding Mortgage is a first lien on additional properties, in respect of which senior securities should also be issued. On this lien question the Refunding Mortgage creditors have relied upon the Trustee, and at least two of them have specifically requested it to obtain review of the decision by this Court.

The Reconstruction Finance Corporation, although it supported the Plan proposed by the Interstate Commerce Commission, has waived none of its rights as a holder of Refunding Mortgage bonds in the event of a favorable determination concerning the relative liens of the First Mortgage and the Refunding Mortgage (R. F. C. Brief in Circuit Court of Appeals, p. 8).

Action of the courts below

The Refunding Mortgage Trustee filed, in the District Court, objections to the Plan (R. 974-79), alleging that the Plan was unfair in failing to award any senior securities to the Refunding Mortgage creditors in recognition of the prior lien which the Trustee claimed upon:

> (1) The Debtor's equity in rolling stock subject to lease, conditional sale agreement or equipment trust; and

(2) A proportionate interest in the Debtor's newly constructed Northern California Extension; and

(3) The undisputed first lien of the Refunding Mortgage upon securities of Central California Traction Company and Alameda Belt Line; and

(4) Their additional rights, in common with general creditors, against non-carrier real estate.

The detailed basis of these objections is left for a later portion of the brief.

The District Court made no independent discussion of the merits of the Refunding Mortgage Trustee's objections with respect to the distribution of new securities, but simply stated, with reference to the capitalization of the new Company as well as the distribution of new securities, that "I am wholly in accord with the conclusions reached by the Commission upon both issues and all matters incidentally related thereto. It seems to me that further discussion would be superfluous" (R. 1597). The Refunding Mortgage Trustee appealed from the District Court's decree approving the Plan, and set forth in its Statement of Points all the lien issues already mentioned (R. 1652-53). The Circuit Court of Appeals, in its opinion, did not discuss the legal questions of conflicting lien and made no determination of the merits of the Refunding Mortgage Trustee's appeal. On the contrary, it ruled that the Refunding Mortgage Trustee was not adversely affected by the Plan, and consequently that it was not entitled to appeal (R. 2668; 124 F. (2d) at 138).

The decree of the Circuit Court of Appeals, entered November 28, 1941, accordingly dismissed the appeal of the Refunding Mortgage Trustee without consideration of the issues presented (R. 2675).

Thereafter, on petition for rehearing filed by the Refunding Mortgage Trustee, the Circuit Court of Appeals set aside (R. 2681) that portion of the decree holding that

the Refunding Mortgage Trustee was not entitled to appeal, but still failed to decide the questions raised by its appeal.

As appears from the other petitions filed in this proceeding, the Circuit Court of Appeals, on the appeals of other creditors, reversed the judgment of the District Court approving the Plan of reorganization, and suggested that the proceeding be referred back to the Interstate Commerce Commission for further action (R. 2674) to determine necessary questions concerning valuation, including

> "The value of (1) the property subject to the refunding mortgage only and (2) the property subject both to the refunding mortgage and to the first mortgage" (R. 2670; 124 F. (2d) at 139).

The properties in dispute

The issues presented by the Refunding Mortgage Trustee in the Circuit Court of Appeals related to the following four major items of property:

1. The Debtor's equity, amounting to approximately $6,000,000 (R. 1074), in equipment purchased under lease, conditional sale, or equipment trust (R. 1244-45). Petitioner's contention is that a proper construction of the two mortgages shows that such equity is expressly free from the lien of the First Mortgage and expressly subject to the lien of the Refunding Mortgage.

2. The Northern California Extension, a branch line running from Keddie to Bieber, which was built at a cost of more than $10,000,000 (R. 1053) and is one of the most profitable portions of the Debtor's road. Petitioner's contention is that the Extension is subject to the First Mortgage only to the extent of the $5,000,000 of First Mortgage money which was used in its construction, and that otherwise it is subject to the prior lien of the Refunding Mortgage, under which the balance of its cost was financed.

3. The securities of Central California Traction Company and Alameda Belt Line, on which it is not disputed

that the Refunding Mortgage is a first lien. The Interstate Commerce Commission did not find the value of these securities, but stated that, because of apparent operating deficits of the companies, the lien on the securities had "no material value" (R. 315). Petitioner's contention is that under the undisputed evidence the Interstate Commerce Commission and the District Court were wrong in treating the lien on these securities as having no value, and that the Refunding Mortgage creditors are entitled to compensation for being deprived of their right to foreclose on and sell these securities.

The Circuit Court of Appeals stated that the Interstate Commerce Commission should find the value of the property subject to the Refunding Mortgage (R. 2670). This will compel a specific valuation of the Central California Traction and Alameda Belt Line securities, which the Commission has not yet undertaken. Consequently, if the decision of the Circuit Court of Appeals stands, the error in respect of these securities will be corrected. If this Court, however, should adopt any different principle of decision from that laid down by the Circuit Court of Appeals, it would become necessary to consider the effect of the lack of findings concerning the value of these securities, as well as the Trustee's claim that the evidence shows that they have substantial value.

4. Non-carrier real estate of the Debtor, together with cash and receivables on hand at the date of the institution of the reorganization proceedings. Petitioner claims that these items are free from both the First Mortgage and the Refunding Mortgage, and must be given consideration, as unmortgaged property, in the allocation of securities to the Refunding Mortgage creditors as well as the First Mortgage creditors in the event it is found that they are not fully secured.

If the contentions advanced by the Refunding Mortgage Trustee with respect to the first 3 items above are sustained, however, the Refunding Mortgage will be fully

secured, and the Refunding Mortgage creditors should receive the same treatment as the First Mortgage creditors.

The facts relating to the several lien questions are so distinct from each other and from the primary question of the error of the Circuit Court of Appeals in leaving the lien questions undecided that the interest of clarity will be served by reserving the statement of such facts to the separate points in the argument.

Specification of errors intended to be urged

The Circuit Court of Appeals erred:

1. In remanding the proceeding to the Interstate Commerce Commission for determination of the value of the property subject to the liens of the various mortgages without making a final adjudication of legal questions squarely and properly presented to it concerning the extent of the liens of such mortgages;

2. In leaving undetermined, upon review of objections to the reorganization plan, questions of law squarely and properly presented to it affecting the priority of lien on over $12,000,000 worth of the Debtor's property;

3. In failing to hold that rolling stock acquired by the Debtor with free funds under equipment-trust agreements was free from the lien of the Debtor's First Mortgage and subject to the prior lien of the Refunding Mortgage;

4. In failing to hold that the Northern California Extension is subject to the lien of the First Mortgage only to the extent of the First Mortgage bonds used in the acquisition thereof, and that otherwise it is subject to the prior lien of the Refunding Mortgage; and

5. In failing to hold that the non-carrier real estate (including the Islais Creek property) is free from both the First Mortgage and the Refunding Mortgage and should be given consideration, as unmortgaged property, in the allocation of securities to the Refunding Mortgage creditors.

Summary of Argument

I. Determination of the property on which creditors respectively hold liens is fundamental to the enforcement of the absolute priority doctrine laid down by this Court.

II. The rolling stock which was acquired under lease or equipment-trust agreement is free from the First Mortgage and subject to the prior lien of the Refunding Mortgage.

The general rule of strict construction is applied to after-acquired property clauses.

The First Mortgage clearly does not cover the equipment-trust rolling stock.

The Commission's interpretation of the equipment-trust clause of the First Mortgage was erroneous.

The practical interpretation shows that the First Mortgage was not considered to cover equipment-trust rolling stock.

Other cases on equipment-trust clauses confirm the Refunding Mortgage Trustee's contention.

III. The First Mortgage Trustee can sustain no claim under the replacement clauses of the First Mortgage which materially affects the rights of the Refunding Mortgage Trustee in the equipment-trust rolling stock.

The equipment covenants apply only to equipment that has been worn out, destroyed or disposed of.

The equipment covenants cannot be satisfied by rolling stock subject to equipment-trusts.

The equipment covenants relating to replacement are not self-executing.

IV. The Northern California Extension is subject to the lien of the First Mortgage only to the extent of the First

Mortgage Bonds used in the acquisition thereof. Otherwise it is subject to the prior lien of the Refunding Mortgage.

No supplemental indenture subjecting Extension to First Mortgage.

Limitations on after-acquired property clauses.

There is no equitable basis for giving the First Mortgage a lien on the Extension beyond the amount which it contributed towards its construction.

V. The Refunding Mortgage bondholders are entitled to additional securities in recognition of their interest in free assets of the Debtor.

I

Determination of the property on which creditors respectively hold liens is fundamental to the enforcement of the absolute priority doctrine laid down by this Court.

The dismissal of the Refunding Mortgage Trustee's appeal was not requested by any party in the Circuit Court of Appeals. The standing of the Trustee to appeal was not questioned either in the briefs or in the argument before that Court. Nor, when the Court of its own motion had dismissed the appeal, did any party file a brief in opposition to the Refunding Mortgage Trustee's petition for rehearing.

It therefore appears necessary at this point only to outline the argument concerning the standing of a mortgage trustee and the duty of an appellate court to decide the issues presented by the mortgage trustee's appeal.

Not only does the Refunding Mortgage expressly authorize the Trustee "to take all steps needful for the protection and enforcement of its rights and the rights of the holders of the General and Refunding Bonds * * *" (I. C. C. Ex. 6, p. 136; see also pp. 135, 142-43, 148-49), but Section

77 of the Bankruptcy Act expressly provides that a mortgage trustee "shall have the right to be heard on all questions arising in the proceedings" (Section 77(c)(13)). Moreover, Rule 17(a) of the Rules of Civil Procedure for the District Courts of the United States permits a trustee to be a party in its own name to any action.

The power and duty of mortgage trustees to protect the mortgage security has been recognized also in many court decisions.

> *Hascall* v. *Wilcox*, 115 U. S. 598, 599-600;
> *Old Colony Trust Co.* v. *Wichita*, 123 Fed. 762, 767 (C. C. Kans.), aff'd. 132 Fed. 641 (C. C. A. 8);
> *Equitable Trust Co.* v. *Denney*, 24 F. (2d) 169, 170 (C. C. A. 7th);
> *Seaboard Nat. Bank* v. *Rogers Milk Products Co.*, 21 F. (2d) 414, 418-19 (C. C. A. 2nd).

The holders of Refunding Mortgage bonds expressly relied upon the Refunding Mortgage Trustee in this case to present the issues respecting the relative liens of the First Mortgage and the Refunding Mortgage. Thus, counsel for the Railroad Credit Corporation stated at the hearings before the Interstate Commerce Commission in 1936:

> "We have relied on counsel for the Trustee to make the case. We have not made the effort to do it ourselves, as to priority." (I. C. C. Min. 550-51)

The A. C. James Co., in its objections in the District Court, referred only briefly to the lien questions, stating (R. 911):

> "In this connection your petitioner concurs in the objections filed herein by the Irving Trust Company as substituted Trustee under the General and Refunding Mortgage."

And the R. F. C., in its brief in the Circuit Court of Appeals, pointing out that it waived none of its rights as a holder of Refunding Mortgage bonds in the event of a favorable determination of the lien questions, stated:

"This will be presented in the briefs of the respective Mortgage Trustees." (Brief, p. 8)

The Circuit Court of Appeals, therefore, should have determined the lien questions on the merits, under the rule stated in *The Bay of Naples*, (48 Fed. 737, 738 C. C. A. 2nd):

> "When the law gives a party a right to appeal, he has the right to demand the conscientious judgment of the appellate court on every question in the case."

This Court has held that it is reversible error to refuse to make a finding one way or another on a question of fact material to the determination of the case. (*The "Francis Wright"*, 105 U. S. 381, 387; *Merchants Insurance Co.* v. *Allen*, 121 U. S. 67, 71.) The same principle should apply to the decision of questions of law raised on appeal.

Determination of the property on which each group of creditors holds liens is fundamental to the enforcement of the doctrine of absolute or full priority pronounced by this Court in *Northern Pacific Railway Company* v. *Boyd*, 228 U. S. 482, and reaffirmed in *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106, 122.

In one of this Court's most recent decisions on the fairness of reorganization plans (*Consolidated Rock Products Co.* v. *duBois*, 312 U. S. 510), the necessity of such a decision was emphatically stated in the following language:

> "In the first place, there must be a determination of what assets are subject to the payment of the respective claims. This obvious requirement was not met" (p. 520).

And again (pp. 524-25):

> "There is another reason why the failure to ascertain what assets are subject to the payment of the Union and Consumers bonds is fatal. There is a question raised as to the fairness of the plan as respects the bondholders *inter sese*. * * * some appropriate formula for at least an approximate ascertainment of their respective assets must be designed in spite of the difficulties occasioned by the commingling."

The opinion of the Circuit Court of Appeals in this very case recognizes the principle of the *Rock Products* opinion, and expressly points out that the determination of the property on which each mortgage is a lien is an essential preliminary to the findings of value which it held the Commission should have made. The opinion below on this point reads as follows:

> " * * * to determine the value of the refunding bonds, it was necessary to determine the value of (1) the property subject to the refunding mortgage only and (2) the property subject both to the refunding mortgage and to the first mortgage now outstanding. *This, of course, necessitated a determination as to which of the debtor's property is, and which is not, subject to each mortgage.* Consolidated Rock Products Co. *v.* duBois, supra" (R. 2670).

Clearly, and beyond dispute, the lien questions are questions of law, which should have been decided by the Court and not remanded to the Commission. The Commission recognized this when it stated, in its report on the present Plan:

> "While final adjudication of this and similar questions must be made by the Court, it becomes our duty, in the absence of such adjudications, to determine them preliminarily for the purpose of consideration of the plans before us" (R. 262).

The District Court likewise recognized it when it stated (R. 1597):

> " * * * The determination of the questions relating to the distribution of the new securities, including legal priorities and allocations, involves private rights and is a judicial function, within the province of the court."

We are confident, therefore, that this Court will rule that the lien question should be decided before any further proceedings are had with respect to the reorganization plan. The only question is whether this Court will decide the questions itself or remand them to the Circuit Court of Appeals (*cf. Grant* v. *Leach & Co.*, 280 U. S. 351).

This Court has power, on certiorari, to dispose of all questions presented by the record

Story Parchment Co. v. *Paterson Parchment Paper Co.*, 282 U. S. 555, 567-68;

Donovan v. *Pennsylvania Company*, 199 U. S. 279, 292;

Delk v. *St. Louis & San Francisco R. R.*, 220 U. S. 580, 588-89.

While this Court might remand the case to the Circuit Court of Appeals for further hearing, even on the same briefs which were submitted previously, this would create delay that can be obviated if this Court itself decides the lien questions,—as its general grant of certiorari indicates a willingness to do. The policy of expediting railroad reorganization (*Continental Illinois National Bank* v. *Chicago, Rock Island & Pacific Railway*, 294 U. S. 648, 685) likewise supports this request.

The principal respondents on this petition, the First Mortgage Trustees, are in agreement with us, we believe, in requesting this Court to decide the lien issues itself. This is indicated by the statement in their petition (October Term, 1941, No. 820):

> "6. In omitting to discuss all of the issues which were before the Circuit Court of Appeals, the decision of the Circuit Court of Appeals has left unanswered many important questions, affecting virtually every feature of the Commission Plan. An authoritative determination of all of these questions is essential to the final approval of a plan of reorganization. Unless these questions are settled by this Court, they are likely to become the subject of further litigation, which will result in further and unnecessary delay and expense to the parties concerned.
>
> * * * * *
>
> To the end that these reorganization proceedings, which have been pending since 1935, may be speedily determined, the petitioners respectfully pray that this Court review the entire case upon the entire record and determine all of the questions involved" (pp. 9-10).

II

The rolling stock acquired under lease or equipment trust agreement is free from the First Mortgage and subject to the prior lien of the Refunding Mortgage.

Neither the initial payment nor any subsequent payment for the rolling stock claimed by the Refunding Mortgage Trustee (hereinafter called "equipment-trust rolling stock") was made out of proceeds of First Mortgage bonds or out of cash deposited under the First Mortgage; all such payments were made either from free funds of the Debtor or from funds derived by pledge of Refunding Mortgage bonds (R. 1073-74).

The equipment-trust rolling stock includes 27 locomotives, 3,626 freight cars of various types, and 48 passenger cars (R. 1071-73). This equipment was originally purchased under, and was subject at the time of the institution of the reorganization proceedings to, Equipment Trust Agreements Series B, C, and D and the Baldwin Locomotive lease (R. 1068-69). Each equipment-trust agreement stated that the equipment was "let and leased * * * to the railroad company" by the trustee under the agreement, and that title was vested in said trustee (Ex. 108, lease p. 2—not printed*), but that it would become the Debtor's property upon final payment. The Baldwin Locomotive lease (Ex. 109) similarly provided that the locomotives covered thereby were leased to the Debtor with title reserved in the Lessor until the covenants of the lease were fully per-

* Pursuant to stipulation (R. 2612-26), which has been approved by this Court, certain exhibits and other papers which constitute part of the record on appeal were omitted from the printed record, with the understanding that they might nevertheless be referred to by any party in brief or argument. Exhibits which were printed are referred to herein by page in the record, unprinted exhibits by the number given them in the Commission or the District Court.

formed. Although there was no trustee under the Baldwin Locomotive lease, the equipment covered by it is included, for simplicity of expression, in the phrase "equipment-trust rolling stock" as used in this brief.

The amounts originally payable under the equipment-trust agreements and Baldwin Locomotive lease amounted to approximately $10,430,000 (R. 1048-49). Application of free funds and of money obtained from Refunding Mortgage creditors (R. 1055) had reduced the indebtedness to $2,682,598 (R. 1074) at the institution of the reorganization proceeding.

The value of the Debtor's equity in the equipment-trust rolling stock at the date of the institution of the proceedings was $6,163,838, after allowance for accrued depreciation (R. 1074).

Although the equipment-trust rolling stock was acquired for use on all the Debtor's lines of railroad, including those specifically described in the granting clauses of the First Mortgage, it was consistently described by the Debtor as not subject to the First Mortgage. In a series of listing statements filed with the New York Stock Exchange in connection with issues of First Mortgage bonds between 1926 and 1932, the Debtor, after describing the property on which the First Mortgage constituted a first lien, stated:

> "The foregoing equipment does not include additional *unmortgaged equipment* covered by equipment trust agreements Series B, Series C and Series D, as follows" (R. 1074).

On the other hand, the equipment-trust rolling stock was included each year in the lists of equipment subject to the Refunding Mortgage, which were furnished to the Refunding Mortgage Trustee in compliance with Article Five, Section 16 of the Refunding Mortgage (R. 1073).

Lists of mortgaged equipment were required by the First Mortgage to be furnished to the First Mortgage Trustees upon request (I. C. C. Ex. 5, p. 77). No evidence was of-

fered by the First Mortgage Trustees that the equipment-trust rolling stock had ever been described as subject to the First Mortgage in any statement furnished to them.

The equipment-trust clause

A specific exception, in the granting clauses of the First Mortgage, permits the acquisition of rolling stock by lease, conditional sale or equipment trust, free from the lien of the First Mortgage. This equipment-trust clause is significantly placed at the very end of the free funds paragraph (R. 1229). The free funds paragraph states that nothing in the mortgage shall limit the power of the company, by use of its credit or of free funds, to acquire equipment or other property free from the lien of the First Mortgage, provided such property does not come within one of four categories: (a) property acquired with the proceeds of First Mortgage bonds, (b) integral parts of the mortgaged railroad, (c) property acquired for use on the mortgaged railroad, or (d) stock of certain subsidiaries; and then concludes with the words, separated by a semi-colon into a complete and final clause, as follows:

> "*and* the Company may, *unless First Mortgage Bonds shall have been authenticated and delivered or their proceeds or other cash deposited hereunder paid out against the same*, purchase and acquire equipment, *free from the lien hereof*, by lease, conditional sale agreement or under any form of equipment trust, or purchase such equipment and issue obligations therefor secured by mortgage or pledge of such equipment superior to the lien of this indenture."

It will be noted that this equipment-trust clause repeats only one of the four provisos of the preceding free funds paragraph, namely, that First Mortgage bonds or their proceeds shall not have been paid out for the purchase of the equipment.

The equipment-trust clause of the Refunding Mortgage, on the other hand, although it begins in the same way, *is followed by a statement, without counterpart in the First Mortgage, placing the equity in such equipment under the Refunding Mortgage.* This statement reads:

> "*provided*, however, that, when and as and to the extent that the title to or any interest, legal or equitable, in rolling stock or equipment, however acquired, for use or used upon or in connection with the lines of railroad and property now or hereafter subject to this indenture, shall vest in the Company or in any successor company operating said lines of railroad and property free in whole or in part from such trust, mortgage or pledge, then the rolling stock or equipment or such interest therein as it becomes vested in the Company or such successor company shall become subject to the lien of this indenture" (R. 1244-45).

Comparing these two clauses, we find that equipment-trust rolling stock was freed in the first instance from the lien of both mortgages, but that immediately afterward, in the case of the Refunding Mortgage, the *equity* was placed back under the mortgage lien, whereas this was not done in the case of the First Mortgage. There would have been no point in expressly placing back the equity in equipment-trust rolling stock under the lien of the Refunding Mortgage if the preceding language of the equipment-trust clause as contained in the Refunding Mortgage (being the same language as contained in the First Mortgage) did not exclude it.

The facts outlined above are not open to controversy, and are not disputed. None of the equipment-trust rolling stock was owned by the Debtor at the time the First Mortgage was created. None of it was financed in any part with First Mortgage funds. No instrument or act of the Debtor ever expressly subjected it to the First Mortgage.

The question is therefore entirely one of the construction of the free funds clause and the equipment-trust clause

of the First Mortgage as applied to after acquired property. In deciding this question of construction the Court is free to draw on arguments from the logical meaning of the mortgage provisions as well as on canons of interpretation laid down by the courts of any jurisdiction.

The mortgage was executed in New York (I. C. C. Ex. 6, pp. 188-97). The mortgagor is a California corporation, and both the original Trustee and the substituted trustee are domiciled in New York. The mortgaged property is located or used within the States of California, Nevada and Utah (Ex. 6, p. 1). Neither party relies on any rules of law or construction which are peculiar to any of these jurisdictions.

In both New York and California the courts will look to the decisions of other common-law jurisdictions for a statement of the applicable law, where no controlling local decision exists:

Davis v. *Modern Industrial Bank*, 279 N. Y. 405, 411;
Lux v. *Haggin*, 69 Calif. 355, 379-380, 384-85;
Fletcher v. *Los Angeles Trust etc. Bank*, 182 Calif. 177, 183-84;
Adair v. *Beverly Hills Petroleum Corp.*, 59 F. (2d) 94 (S. D. Calif.).

The general rule of strict construction of after-acquired property clauses.

If there were room for doubt that the equipment-trust rolling stock is free from the First Mortgage, the doubt would be resolved by the rule that after-acquired property clauses must be strictly construed, and that property acquired after the execution of a mortgage will not be brought under its lien unless the intention so to do is expressed beyond dispute.

This rule was stated in *Cleveland Trust Co.* v. *Consolidated Gas, E. L. & P. Co.*, 55 F. (2d) 211 (C. C. A. 4) in the following words:

> "The great weight of authority sustains the rule of strict construction in interpreting 'after acquired property' clauses in a mortgage. To use the words of the court, in the case of Smith *v.* McCullough, 104 U. S. 25, 26 L. Ed. 637, the terms employed in describing the property mortgaged must 'imperatively demand' the construction contended for" (p. 214).

To the same effect are

Guaranty Trust Co. v. *Minneapolis & St. L. R. Co.*, 36 F. (2d) 747, 751 (C. C. A. 8);
Westinghouse Electric and Mfg. Co. v. *Brooklyn R. T. Co.*, 263 Fed. 532, 536 (C. C. A. 2).

Mr. Swaine, counsel for the Institutional First Mortgage Bondholders, recognized this rule when he stated before the Commission that it was part of his affirmative case to show what the First Mortgage lien is (R. 2303).

The First Mortgage clearly does not cover the equipment-trust rolling stock.

Not only has the burden resting upon the First Mortgage not been sustained, but the granting clauses of the two mortgages clearly and affirmatively show that the Refunding Mortgage (as is not disputed) is a lien on the equipment-trust rolling stock and that the First Mortgage is not.

The principal argument advanced by the First Mortgage Trustees for claiming that the equipment-trust rolling stock is subject to their Mortgage is that it was acquired for use on the mortgaged railroad and therefore should be excluded from the operation of the equipment-trust clause. However, this argument is not based on any express language of the equipment-trust clause, which, on the contrary, expressly fails to make any exception for equipment used on the mortgaged line. As a practical matter, the First Mortgage Trustees' argument would severely limit the

operation of the equipment-trust clause, since the only equipment to which the clause could apply, under their argument, would be equipment bought for use exclusively on after-acquired branches or extensions not financed with First Mortgage funds and which was never used on the main line. Such a limitation would be unreasonable, and also contrary to sound railroading practice, for efficient use of equipment requires that it be available for use on any portion of the railroad's property.

It will be noted that in the first part of the free funds clause (R. 1228-29) there are *four* limitations, one of which—(c)—is the limitation upon which the First Mortgage Trustees rely. However, it will also be noted that before the last sentence of the paragraph, and separated by a semicolon and the correlative conjunction "and" from the preceding clause, appears the separate clause covering equipment acquired under lease or equipment trust, and that this clause has only *one* limitation, relating to the use of First Mortgage bonds or deposited cash.

There would have been no point in repeating this one exception in the equipment-trust clause if it had been intended that all four of the limitations in the earlier paragraph apply to property acquired under the equipment-trust clause. Conversely, the statement of this one limitation makes it as clear as language can make it that the other limitations (including limitation (c), upon which the First Mortgage Trustees rely) do not apply to property acquired under the equipment-trust clause.

The absence of a provision, such as is contained in the Refunding Mortgage, to put the equity of the equipment-trust rolling stock under the lien of the First Mortgage only serves to emphasize what the language of the equipment-trust clause in the First Mortgage clearly expresses, namely, that "the Company may * * * acquire equipment, free from the lien hereof * * * under any form of equipment trust", provided only that it is not bought with proceeds of First Mortgage bonds.

The Commission's interpretation of the equipment-trust clause was erroneous.

The reason given by the Commission (R. 266), and adopted without comment by the District Court, for rejecting the Refunding Mortgage Trustee's claim was that treating such equipment as free from the lien of the First Mortgage would be inconsistent with the paragraph in the habendum clause of the First Mortgage which reads:

> "SUBJECT, HOWEVER, as to all equipment now owned to the equipment trust or conditional sale agreements secured thereon, and as to equipment hereafter acquired, to the equipment trust or conditional sale agreements to which the same shall be subject as permitted hereby * * *."

The Commission argued (R. 266) that "If all equipment acquired under equipment trusts was to be entirely free of the first mortgage", the reference in the subject clause to a permitted lien on equipment-trust rolling stock could not be explained.

The basic error in this reasoning lies in the Commission's use of the word "all". The Refunding Mortgage Trustee has never argued that *all* equipment acquired under equipment trusts must be entirely free of the First Mortgage, but only that it is free of the First Mortgage if acquired without the use of First Mortgage Bonds or cash. As already quoted, the First Mortgage provides that such equipment-trust rolling stock should be free from the Mortgage

> "* * * *unless First Mortgage Bonds shall have been authenticated and delivered or their proceeds or other cash deposited hereunder paid out against the same* * * *" (R. 1229).

The Commission overlooked that the First Mortgage contemplates that rolling stock may be acquired under equipment trust either (1) with First Mortgage funds—

in which event the First Mortgage will be a lien thereon "subject * * * to the equipment trust or conditional sale agreements * * * permitted hereby", or (2) with free funds —in which event it will be "free from the lien hereof".

Other provisions of the First Mortgage (in clauses subsequent to the granting clause) expressly cover the use of First Mortgage funds for the purchase of property which is subject to equipment-trust or other prior liens. Purchase of equipment is one of the purposes for which First Mortgage Bonds or cash are expressly permitted to be used (Ex. 5, Art. Second, Sec. 2, Par. A, Clause (b), p. 41). Paragraph E of the same Section which covers issuance of Bonds for new equipment provides (Ex. 5, pp. 57, 58) that whenever the certificate delivered to the Trustees to draw down cash or bonds for the purchase of additional property "shall state the existence of any lien, charge or indebtedness", there shall be reserved from delivery First Mortgage bonds or cash equal to the face amount of such liens or charges, and provides that these shall be delivered only after the payment or redemption of such "liens, charges or indebtedness".

The "liens" or "charges" subject to which property may be purchased with First Mortgage funds include the lien of equipment-trust agreements, for paragraph G of the same Section defines the words "lien" and "charge" as used in that Section to include

> "deferred instalments of the purchase price of property in every case where title thereto has not been vested in the purchaser or, having so vested, is subject to a vendor's lien or any right of the seller to retake or enforce a charge upon such property upon default in the payment of such deferred instalments of the purchase price and also the *deferred payments to be made or rentals to be paid under any conditional sale agreement or lease or trust agreement covering equipment*" (Ex. 5, p. 60).

At least one example appears in the record of First Mortgage funds being drawn down for the purchase of prop-

erty subject to liens, with the First Mortgage Trustees withholding the amount of such lien until satisfied that the lien had been discharged (R. 2549-2550).

In other words, there is a class of equipment-trust rolling stock to which the First Mortgage may attach, that is, equipment on which the down payments are made from First Mortgage funds.

Therefore the "Subject, however" clause can and should be given meaning without detracting from the plain language of the equipment-trust clause, which excludes equipment-trust rolling stock from the lien of the First Mortgage if not financed with First Mortgage funds.

The interpretation urged by the Refunding Mortgage Trustee gives effect to every part of the First Mortgage granting clauses. Property may be acquired under equipment trust or conditional sale by the use of First Mortgage funds, and it will then be under the First Mortgage, but subject to the prior lien of the equipment trust "as permitted hereby" (First Mortgage, I. C. C. Ex. 5, p. 22). Or it may be acquired by equipment trust or conditional sale without the use of First Mortgage funds, and then it will be "free from the lien" of the First Mortgage.

On the other hand, the interpretation which the District Court approves gives no effect to the provision of the First Mortgage that equipment-trust rolling stock is free from the Mortgage lien "unless First Mortgage Bonds shall have been authenticated * * * against the same", for it makes the lien applicable to all equipment-trust rolling stock whether or not it is purchased with First Mortgage funds. Furthermore, such an interpretation would make unnecessary the express language of the Refunding Mortgage which subjects the equity in such equipment to the Refunding Mortgage.

The Refunding Mortgage Trustee's interpretation is therefore supported not only by the rule of strict construction of after-acquired property clauses, but also by the rule laid down in the following authorities, that a construction

which gives effect to all provisions of an instrument is preferable to one which nullifies the meaning of any portion:

Westinghouse Electric & Mfg. Co. v. *Brooklyn R. T. Co.*, 276 Fed. 152, 158 (S. D. N. Y.);
Canadian Northern Ry. Co. v. *Northern Mississippi Ry. Co.*, 209 Fed. 758, 761-2 (C. C. A. 8);
E. I. Du Pont De Nemours & Co. v. *Claiborne-Reno Co.*, 64 F. (2d) 224, 228 (C. C. A. 8);
2 Williston, Contracts (Rev. Ed.), Sec. 619.

The practical interpretation shows that the First Mortgage was not considered to cover equipment-trust rolling stock.

As shown in the statement of facts, the Debtor repeatedly indicated its understanding that the equipment-trust rolling stock was subject to the Refunding Mortgage but free from the lien of the First Mortgage, not only by listing it as so subject in reports furnished to the Refunding Mortgage Trustee and omitting any similar reports to the First Mortgage Trustees, but by express description thereof in listing statements, prior to the issuance of the Refunding Mortgage, as "additional *unmortgaged* equipment covered by equipment trust agreement" (R. 1074).

The First Mortgage Trustees have disputed the relevancy of the listing applications, on the theory that they are not binding upon the First Mortgage bondholders. This position is not justified. Stock Exchange listing applications are prepared contemporaneously with the issuance of the bonds covered thereby, are filed as the basis for obtaining a nation-wide market for such bonds, and constitute a public summary of the conditions affecting such bonds, which are available to every bondholder and which are among the sources of general information concerning such bonds.

The use of listing statements as a source of interpretation was approved by this Court in *Continental Insurance Co.* v. *United States*, 259 U. S. 156, 180, where it stated that not only was the corporation which filed the statement the

representative of the security holders (stockholders in that case), but that the statement

> "has the additional weight of a representation to future purchasers of the two classes of stock as to the kind of interests they were buying in the Company" (259 U. S. at 181).

See also

In Re New York, N. H. & H. R. Co., 27 F. Supp. 392, 395, affd. on op. below, 104 F. (2d) 1018 (C. C. A. 2);

Cunningham v. *Pressed Steel Car Co.*, 238 App. Div. (N. Y.) 624, 627; 265 N. Y. Supp. 256, 260;

Continental Ins. Co. v. *Minneapolis, St. P. & S. S. M. Ry. Co.*, 283 Fed. 276, 278 (D. Minn.).

Other cases on equipment-trust clauses confirm the Refunding Mortgage Trustee's contention.

In two other cases similar mortgage covenants have been construed, and in both cases the result clearly supports the claim of the Refunding Mortgage Trustee. One case is a decision by Judge Sanborn in the first *Wabash Receivership* (unreported, but printed in the record herein—R. 1721-34), and the other is a recent decision by Judge Wilkerson in the *Rock Island Reorganization* (also unreported).

1. The decision of Circuit Judge Sanborn, rendered November 7, 1921, in the United States District Court for the Eastern District of Missouri in *The Equitable Trust Co.* v. *Wabash Railroad Co.* (In Equity No. 3977), held that certain after-acquired locomotives purchased under equipment-trust agreements did not come within the language of the granting clauses of the Wabash Refunding Mortgage; and then went on to hold that even if they were covered they were taken out from under the mortgage by the exception clause. The Wabash Refunding Mortgage included by reference the property which was subject to

underlying mortgages, one of which, like the First Mortgage in this case, covered all after-acquired property "used" "in connection with" the mortgaged railroads (R. 1725). Judge Sanborn held that in spite of this language the Wabash Refunding Mortgage was not intended to include the interest of the mortgagor in locomotives which were purchased after the date of such mortgage through equipment trusts. After so holding he stated:

> "But supposing that the paragraph quoted from the mortgage of July 1, 1889, is broad enough to cover the interest which the mortgagor secured in the seventy locomotives in October 1907 and thereafter under the equipment agreement; * * *. Nevertheless, it was competent for the parties to that mortgage, by a stipulation therein, to except that interest from the lien thereof." (R. 1727).

The free funds clause in that case read:

> "'But it is hereby covenanted and agreed that the Railroad Company reserves the right, except as in this indenture expressly otherwise provided * * * to acquire any stocks, bonds, securities and other property of any kind and description free from the lien of this indenture and any railroad, branch or extension and any stocks, bonds, securities and other property of any kind or description, acquired by the Railroad Company without the use of bonds or proceeds of bonds issued hereunder * * * shall, except as in this Indenture expressly otherwise provided, be free from the lien of this Indenture unless specifically subjected thereto by an instrument in writing * * *'." (R. 1728).

The discussion of this clause in the opinion attaches particular significance to its location at the end of the granting clause (the same position occupied by the equipment-trust clause of the Western Pacific First Mortgage). Judge Sanborn further stated:

> "But (1) if the granting parts of the mortgage fail to evidence an intention of the parties to subject after acquired locomotives, procured through equip-

ment trust agreements, to the lien of the refunding mortgage, they were not subjected thereto by the reservation paragraph, and the question presented by this contention becomes immaterial; (2), if, on the other hand the granting clauses do evidence such an intention, the position of the reservation paragraph in the mortgage after all the descriptions of the property granted and just before the habendum paragraph, its independent, clear and sweeping covenant in these terms 'but it is hereby covenanted and agreed that the railroad company reserves the right, except as in this indenture expressly otherwise provided, to acquire or construct any railway, branch, or extension and to acquire any stock, bonds and other property' not other property of the kinds therein described, but 'of any kind and description free from the lien of this indenture' etc., and the evident purpose of this paragraph to carry out thereby the intention expressed in the authorizing resolution seem to the court, to converge with almost compelling force to persuade that the construction which this contention seeks to apply to the reservation never was intended by the parties to it, * * *" (R. 1732-33).

The foregoing reasoning applies directly to the Western Pacific First Mortgage. It was competent for the parties to except the interest in equipment-trust rolling stock from the lien of the mortgage; and the position of the equipment-trust paragraph in the mortgage after all the description of the property and just before the habendum paragraph, together with its independent statement of the only exception to such freedom—namely, the use of First Mortgage funds in the acquisition of such equipment—prove with compelling force that the construction which the First Mortgage Trustees now claim was never intended by the parties to the Mortgage.

Judge Wilkerson's opinion was rendered on October 31, 1939, in the United States District Court for the Northern District of Illinois, in the *Chicago, Rock Island and Pacific Railway Company* reorganization. (See record in that case, pp. 2807-38.) It involved the construction of two

separate mortgages, each of which resembled the Western Pacific First Mortgage in important particulars. The first, the General Gold Bond Mortgage, referred in its granting clauses to equipment "*hereafter acquired* * * * *for use upon*" the mortgaged Railway, which is substantially the language upon which the First Mortgage Trustees here rely. It also contained a proviso in the following language, which closely resembles the general proviso in the Western Pacific First Mortgage:

> "'And *Provided,** further, that nothing in this indenture contained shall be construed to limit the right or power of the Railway Company, hereby expressly reserved, to own and hold, or in any manner, *except by the use of bonds secured by this indenture*, to construct or to acquire, by purchase or by lease, other lines of railway, branches or extensions, *or** equipment or interest therein, *or** new terminals, and to hold and to dispose of, any line or property so acquired, and to retain the proceeds thereof free from the lien of this indenture'" (CRI&P rec., p. 2817).

The Court overruled a contention that the words "or equipment or interest therein" in the proviso must be held to relate only to equipment not intended for use on the mortgaged railway, stating, among other things:

> "If the parties intended that only after-acquired equipment, obtained by the railway company on its own credit for use upon lines of railway not subject to the mortgage, should be excluded from the mortgage lien, there was no reason why that intention could not have been stated in clear and unmistakable terms. The intention should not be left to be determined by conjecture or inference if two provisions or clauses, not harmonious on their face, can be reconciled by allocating to each a separate field of operation that will not be in conflict with the other. That result follows by a determination that the after-acquired property clauses apply to equipment later

---

* Words followed by asterisk are italicized in the mortgage.

acquired to replace equipment no longer fit for service, and equipment acquired by the use of general mortgage bonds; and that equipment later acquired by the railway company on its own credit, without further qualification, is not subject to the mortgage lien." (CRI&P rec., p. 2821).

The other mortgage interpreted in the *Rock Island* case, was known as the First and Refunding Mortgage. The granting clauses covered equipment "appurtenant to" any of the mortgaged lines of railway (Opinion, CRI&P rec., p. 2822); and also property of every kind and description "acquired for use" upon the mortgaged lines (Opinion, CRI&P rec., p. 2826). It contained the following free property clause:

> "But nothing expressed or implied in this indenture is intended, or shall be construed, (a) to limit the right or power of the Railway Company, hereby expressly reserved, by the use of its credit, * * * or *in any manner other than by the use of bonds issued or to be issued under the provisions of * * * this indenture*, or their proceeds, to construct or acquire lines of railway, branches or extensions, or interests therein, or other property, free from the lien hereof:" (p. 2827).

The Court again held that the application of the free property clause was not limited to property acquired for use on lines free from the mortgage, stating:

> "But the suggestion is made that the words 'or other property' in the free property clause, if those words include equipment, should be construed to include only that equipment, acquired by the railway company with free money, that is purchased for use on other lines of railway, branches or extensions that have been acquired with free money, and are not, therefore, subject to the mortgage lien. No such limitation or restriction is to be found in the free property clause. * * *" (p. 2829).
>
> "* * * If the parties had so intended, there were numerous specific words and sentences that could have been used clearly to express such intention.

Without clear expression of such intention it is not proper to supply it by judicial determination where the language in dispute can be otherwise applied" (p. 2831).

The equipment-trust rolling stock has been shown to be free from the First Mortgage by the language of that Mortgage, by analysis of well-considered decisions, and by the practical interpretation of the properties. It is not disputed or disputable that it is subject to the Refunding Mortgage. Its value is so substantial that the creditors secured by Refunding Mortgage bonds are plainly entitled, on the basis of their lien on $6,000,000 worth of such equipment, to far better treatment than is given by the Plan,—which is based on their having only a second lien thereon.

III

The First Mortgage Trustees can sustain no claim under the replacement clauses of the First Mortgage which materially affects the rights of the Refunding Mortgage Trustee in the equipment-trust rolling stock.

The First Mortgage Trustees contended in the District Court (although no such contention had been made before the Commission) that even if the equipment-trust clauses excepted the equipment-trust rolling stock from the First Mortgage, it became subject to the First Mortgage by reason of the replacement provisions thereof.

Again the facts are undisputed. The net book value of equipment subject to the First Mortgage which has been retired or otherwise disposed of is only $442,287.* The

* The gross retirals to March 1, 1932, when the Refunding Mortgage became a lien, amounted to $690,912 (next-to-the-last sheet of Exhibit G to Stipulation of Facts not in Dispute—not printed), while equipment acquired with free funds (other than equipment-trust rolling stock), together with additions and betterments to the First Mortgage equipment from free funds, aggregated $248,625, (Exhibit G, 3d and 6th to 16th sheets).

First Mortgage Trustees, however, assert that they are entitled under the replacement clauses to have allocated to them from any free equipment a total book value equal to the aggregate accrued depreciation on equipment subject to the First Mortgage, which depreciation aggregates over $5,000,000 (Exhibit G to Stipulation of Facts not in Dispute).

The only two covenants in the First Mortgage imposing any obligation to acquire new equipment are restricted to equipment worn out, destroyed or disposed of. Article Fourth, Section 9 of the First Mortgage (Ex. 5, p. 76—not printed), contains a covenant (herein termed the "maintenance covenant") that all equipment subject to the Mortgage shall be marked so as to identify the same as subject thereto, and that the Company

> "will at all times keep such equipment in good order and condition, reasonable wear and tear excepted, * * * and will replace such of said equipment as shall be worn out or destroyed with other equipment of at least equal value on which this indenture shall constitute a first lien" (p. 76).

In Article Seventh, Section 5 of the First Mortgage (p. 111), there is also a provision (herein termed the "replacement covenant") permitting the Company "to dispose of" mortgaged equipment "free from the lien" of the Mortgage if it has "become unsuitable or unnecessary for use",

> "first or simultaneously replacing the same by new * * * equipment * * * of substantially equal value to the Company, which shall become subject to the lien of this indenture in like degree * * *" (p. 111).

The issue therefore is whether the replacement covenant or the maintenance covenant requires Debtor to supply new equipment annually to the extent (in cost) of the book-keeping charge made in that year for depreciation of existing equipment or only to the extent that existing equipment has been disposed of, worn out or destroyed. We believe the language of the instrument and the authorities clearly support the latter conclusion.

The equipment covenants apply only to equipment that has been worn out, destroyed or disposed of.

The maintenance covenant does not require any guarantee against depreciation, but on the contrary states only that the equipment is to be kept "in good order and condition, *reasonable wear and tear excepted*". This statement clearly relates to the repair of existing equipment, not the acquisition of new equipment. There is no allegation or proof of failure to comply with the covenant to keep the First Mortgage equipment in good repair. The second clause of the maintenance covenant contains a provision requiring replacement of such equipment "as shall be worn out or destroyed". This is not a covenant to provide new equipment before the old is worn out or destroyed; in fact it is clear evidence that no equipment need be acquired to satisfy the First Mortgage until the old equipment has been worn out or destroyed.

The replacement covenant relates to a case where the company has undertaken "to dispose of" mortgaged equipment which has "become unsuitable or unnecessary for use". There is no evidence that any First Mortgage equipment has been so disposed of, or has become unsuitable or unnecessary for use. Consequently, there is nothing to bring the replacement covenant into play.

From the above it is obvious that nothing in the equipment covenants justifies an interpretation that, to the extent of annual depreciation charges against equipment, the railroad must acquire new equipment in which it has an equity equal to the amount of such depreciation. Yet the substance of the First Mortgage Trustees' argument is that these carefully drafted covenants should be treated as if they imposed such an obligation.

The equipment covenants cannot be satisfied by rolling stock subject to equipment trusts.

Another feature of the covenants defeats the construction which the First Mortgage Trustees attempt to place on them. Both covenants require that the replacement items shall be subject to the first lien of the mortgage, which cannot be true in the case of rolling stock acquired under lease or equipment trust.

The maintenance covenant states that equipment that is worn out or destroyed must be replaced with other equipment "on which this indenture shall constitute a first lien". The replacement covenant requires that equipment which has been disposed of be replaced by new equipment "which shall become subject to the lien of this indenture in like degree". The company could not give anything better than a second lien on equipment-trust rolling stock, and therefore could not satisfy those covenants except by equipment which was bought free and clear. The First Mortgage Trustees could not properly (assuming, contrary to the fact, that any deficiency existed in respect of equipment) have accepted equipment-trust rolling stock as replacement of items worn out, destroyed or disposed of. *A fortiori*, they cannot claim such items after the lien of a new mortgage has attached to them.

Maintenance and replacement covenants similar to those in the Western Pacific First Mortgage were interpreted in accordance with our argument herein in *Chase National Bank* v. *Mobile & Ohio R. R. Co.* (S. D. Ala., Civil Action No. 56, Special Master's report filed March 25, 1940, confirmed June 14, 1940—not officially reported) where the special master stated:

> "* * * From my construction of the Montgomery Divisional Mortgage, the security demanded, insofar as it concerned rolling stock, was sufficient rolling stock to amount in value to the rolling stock orignally purchased, subject to wear and tear. The reason I

say subject to wear and tear is that *it was the intention of the parties replacements should not be made until items of rolling stock became unfit for use*, and the evidence shows that this happened at various times over a long period."

"I believe that the parties to the Montgomery Division Mortgage intended to provide, and did provide for a lien upon all equipment originally purchased and the replacements that later were purchased, and I have so found. The latter lien would be on the rolling stock of Mobile and Ohio in valued amount sufficient to replace the original equipment *in its depreciated condition. Guaranty Trust Company* v. *Minneapolis & St. L. Ry. Co., supra.*"*

The equipment covenants relating to replacement are not self-executing.

Neither the Debtor nor the First Mortgage Trustees had taken any steps to subject the equipment-trust rolling stock to the First Mortgage prior to the time when the Refunding Mortgage became a lien thereon. In fact, no steps were taken by either party prior to the filing of the Debtor's petition for reorganization,—or for that matter, prior to the filing in 1940 of the First Mortgage Trustees' brief in the District Court.

Under such circumstances, even if there were any basis for a different interpretation of the extent of the equipment covenants, they could not bring the equipment-trust rolling stock under their lien. The First Mortgage provides a definite method to determine what property, if any, is allocated as replacements. This method—the marking of the equipment "so as to identify the same as equipment subject to this indenture"—was not followed. Nor was any of the equipment-trust rolling stock described in any list of mortgaged equipment furnished to the First Mortgage Trustees under the provisions of the Mortgage (p. 77).

* 36 F. (2d) 747 (C. C. A. 8).

As against a subsequent mortgagee, the First Mortgage Trustees clearly have no right to claim that equipment which was acquired as free equipment must be treated as if it had been subjected to their Mortgage as replacements. There would be no way, in the absence of marking or other specific allocation, of knowing what equipment was thus mortgaged.

Similar replacement covenants were held not to give a lien on free rolling stock in a decision of Justice (then Judge) Shiras, in *United States Trust Co.* v. *Wabash Western Ry. Co.*, 38 Fed. 891 (C. C. S. D. Iowa). A covenant in a divisional mortgage there required that a certain amount of rolling stock be assigned to the division and appropriately marked, and that the company at all times keep a definite amount of rolling stock designated as belonging to the division. The Court held that a deficiency in complying with this covenant could not be made good by subjecting to the mortgage cars taken from the railway's general equipment, stating:

> "The findings of the master show that the covenant in the mortgage, that the mortgagor would equip the Omaha Division with rolling stock proportionately equivalent in amount to that used upon the other portions of the system, has not been performed, and it is claimed on behalf of the present purchasers that the deficiency should be made good by assigning a sufficient number of cars out of the general equipment of the Wabash, St. Louis & Pacific Railway to make the equipment equal to what it would have been had the covenant been performed. If this were done, the cars so taken would reduce to that extent the security of other mortgagees, who are not in fault. If no other interests were involved, save those of the mortgagor and the mortgagees of the Omaha Division, it might be that specific performance of the covenant in this particular could be decreed, but whether the decree would be for the assignment of specific rolling stock already in the possession of the company or for the purchase of other stock would be an open question, and it is doubtful whether a court of equity would undertake to give relief in

this form. But however this may be, it is clear that when the question is presented, as it now is, upon this record, the court is not justified in attempting to enforce the covenant in the manner indicated. *The liens of other mortgages have attached to the equipment in question, and the court is not justified in attempting to displace or defeat these liens, in order to make good to the mortgagees of the Omaha Division the loss resulting from the breach of the covenant in their mortgage.* Practically it is a question of lien, and the mortgagees under the latter mortgage are entitled to assert a claim only to such rolling stock as *in fact* became subject to the lien of the mortgage of February 15, 1879" (pp. 892-3).

The First Mortgage Trustees have cited Judge Wilkerson's unreported opinion in the *Rock Island* case (mentioned above, p. 29) as being to the contrary. The opinion there held that each mortgage was entitled to credit against the "disputed equipment" for the amount necessary to "*replace*" original equipment. In fixing a formula for calculating the rights in "disputed equipment" the Court charged "disputed equipment" with the difference between the original cost of mortgaged equipment and the original cost, less depreciation, of such equipment which was in service at the date of the reorganization. The effect of this may be said to be the recognition of a lien equal to the dollar amount of depreciation, but the distinction between depreciation of existing equipment and replacement of equipment which was worn out, destroyed or disposed of does not appear to have been argued before him. Clearly, the obligation stated in the opinion to "replace" original equipment does not support a decree which requires the addition of equipment which does not replace non-existent equipment.

In any event the covenants in the Western Pacific First Mortgage clearly require only the replacing of equipment which has been removed from the Mortgage lien and not the addition to the mortgaged property of new units where the mortgaged units are still in service, having merely suffered *depreciation* through normal use.

Moreover, the interpretation which the First Mortgage Trustees urge would be contrary to the rulings of the Circuit Court of Appeals for the Seventh Circuit, which are controlling on Judge Wilkerson's Court. That circuit has followed the *Wabash Western* case in *Metropolitan Trust Co.* v. *Chicago & E. I. R. Co.*, 253 Fed. 868, 879, where, after holding that a covenant similar to that in Article Seventh, Section 5 of the Western Pacific First Mortgage, was not a replacement covenant, the Court ruled that a replacement covenant would not be effective in any event to impose a lien as distinguished from a general claim for breach of contract, stating:

> "* * * But if it were there, or if the provisions present were properly to be construed as such a covenant, no lien would attach merely because of the mortgagor's breach of the covenant through its failure to maintain and replace the Coal Company equipment in 1894. United States Trust Co. *v.* Wabash W. Ry. Co. (C. C.) 38 Fed. 891; Fosdick *v.* Schall, 99 U. S. 235, 25 L. Ed. 339" (p. 879).

Thus it appears that nothing in the First Mortgage covenants placed under said Mortgage any equipment-trust rolling stock acquired with free funds which had not become subject to the First Mortgage by March 1, 1932, the effective date of the Refunding Mortgage. None of the equipment-trust rolling stock having become subject to the First Mortgage up to that time, it became expressly subject to the Refunding Mortgage on that date and could not, under any theory, be taken out from under the Refunding Mortgage to replace First Mortgage equipment because of events occurring after March 1, 1932.

A similar principle was applied in *Guaranty Trust Co.* v. *New York & Queens Co. Ry. Co.*, 253 N. Y. 190, 170 N. E. 887. In that case an underlying mortgage made by Steinway Railway Company covered a powerhouse and a car-barn. Later, after these properties had partly deteriorated, the Steinway Company was merged into New York & Queens County Railway Company. The merged company made a new ("consolidated") mortgage, and acquired a new par-

cel of land for a new carbarn and new powerhouse, continuing to use the old carbarn as a repair shop and the old powerhouse for a time, and then scrapping them.

The claim of the Steinway bondholders that the new carbarn and powerhouse should be considered subject to the after-acquired property clause of the Steinway mortgage was denied in an opinion by Judge Cardozo, who stated in part (253 N. Y. at 210-11, 170 N. E. at 894):

> " * * * At all events, the line was not a shell when the newly-acquired property came under the lien of the consolidated deed of trust. During a substantial period thereafter, it was maintained not only with its own power house and barn, but with equipment and machinery properly kept up. For any loss that has been suffered through the removal at a later time of this equipment and machinery, the plaintiff had its remedy, equitable or legal. Even now it does not show the relation between the value of the equipment and machinery and the value of the land and buildings, part of the old line. The failure of the Steinway bondholders or of the plaintiff as their spokesman to take advantage of remedies, preventive or reparative, did not divest a lien in favor of the consolidated bondholders attaching in the interval."

IV

The Northern California Extension is subject to the lien of the First Mortgage only to the extent of the First Mortgage Bonds used in the acquisition thereof. Otherwise it is subject to the prior lien of the Refunding Mortgage.

Facts

Less than half the total cost of the Northern California Extension was supplied from proceeds of First Mortgage bonds (R. 1078). Much less than half the cost of the land on which it was built was paid from proceeds of First Mortgage bonds (R. 1082-84). It is not described in the First

Mortgage, or covered by any supplemental indenture subjecting it to the lien of the First Mortgage (R. 1077); on the other hand, it is specifically mentioned as one of the branches mortgaged under the Refunding Mortgage (R. 1236).

The inequity of the First Mortgage Trustees' assertion of an exclusive prior lien on the Extension to the extent of the entire $50,000,000 of First Mortgage bonds outstanding, and to the complete exclusion of the Refunding Mortgage creditors who supplied more than half its construction cost, is emphasized by the fact that the Extension has proved to be the most valuable part of the Debtor's entire road.

The cost of construction of the Northern California Extension was $10,183,641.90 up to May 31, 1932 (R. 1078). Some additional amounts were spent after that date, although it was placed in operation for freight service on June 1, 1932 (R. 1077). Of such total cost, the sum of $5,000,000 was supplied by A. C. James Company, under debentures which were subsequently exchanged for notes secured by Refunding Mortgage bonds; the sum of $4,875,000 was supplied from the proceeds of sale of First Mortgage bonds (R. 1047); and the sum of $559,408 was supplied by Reconstruction Finance Corporation under notes secured by Refunding Mortgage bonds (R. 1088). Were it not for the application of the funds advanced by Refunding Mortgage creditors, the line could not have been completed, for not only did it cost over twice as much as the $5,000,000 originally contemplated (R. 2321), but, as was stated in the Debtor's petition to the Interstate Commerce Commission for authority to borrow from the Reconstruction Finance Corporation the sums necessary to complete contract obligations, "failure by the carrier to make the payments under its contract renders the carrier subject * * * to the enforcement of a lien upon its property" (Ex. 52, p. 647).

The Extension is probably worth much more than it cost. At any rate, there has been no suggestion that it is worth less than it cost.

The Northern California Extension, in conjunction with the Great Northern Railway, furnished a new route to the north and a source of entirely new traffic, which increased tremendously after the first full year of operation (R. 1935). The Interstate Commerce Commission's report stated that further increased traffic over the Extension could be reasonably expected (R. 215). All the traffic estimates indicated a greater percentage increase for traffic over the Northern California Extension, than over the balance of the system (R. 1980, 1942-48).

Although the Northern California Extension represents less than 10% of the total system mileage, it has produced approximately 20% of the total system revenue, an average of over $3,000,000 of freight traffic per year since 1936 (R. 1268), and nearly $3,500,000 in 1939 (R. 1306). Figures for later years are not in the record, but the predictions in the testimony were that it would increase in relation to the balance of the road. The figures just given include the revenue for carrying Northern California Extension traffic over other parts of the system, but it appears that practically none of this traffic would accrue to the system if it were not for the existence of the Extension (R. 1316). The cost of operation of the Extension is less than $400,000 (R. 2195), and its net earnings available for interest are estimated at approximately $500,000 (R. 220).

Moreover, the Northern California Extension was in first-class condition when the reorganization proceedings began, and required no improvements of any importance (R. 2224), whereas considerable amounts had to be spent on the improvement of the system as a whole during the period of reorganization.

It is no wonder that counsel for the First Mortgage bondholders described the Extension as "a very important piece of line" (R. 2438), and conceded that the decision of the question of the lien on the Extension would have a direct bearing upon the fairness of the Plan treatment.

No supplemental indenture subjecting Extension to First Mortgage.

No supplemental indenture was ever executed subjecting the Extension to the First Mortgage (R. 1077). It was not part of the line which the Debtor was authorized to operate at the time of its incorporation, but was first mentioned in an amendment to the certificate of incorporation in 1929 (R. 1076-77). Thus there was no evidence of an intention in 1916, when the First Mortgage was executed, that it should cover any such new line of railroad. It is inconceivable that such an important acquisition as the Northern California Extension would not have been expressly subjected to the First Mortgage if it had been intended to be entirely subject to the entire First Mortgage.

The First Mortgage permits the Debtor to draw down $1,000 worth of First Mortgage bonds for every $1,000 spent on additions or extensions (Ex. 5, pp. 44 to 45). This lends added significance to the fact that, out of the total cost of land for transportation purposes for the Northern California Extension of $504,590.66 (R. 1084), the requests for First Mortgage moneys show an expenditure therefrom of an aggregate of only $196,805.73 (R. 1082-83), *or less than 40% of the cost of land supplied from First Mortgage money.*

Even the "specifications of the securities offered for sale" at the time of the issue of the First Mortgage bonds (Ex. 93) which were used in financing the Extension did not promise a first lien upon the entire Extension. They read:

> "Said First Mortgage constitutes a first lien on the main line of railroad of the Company extending from San Francisco, California, to Salt Lake City, Utah, and branches, aggregating 1050.5 miles, more or less, of first track, the Company's terminal and other railroad properties in the cities of San Francisco, Oakland and elsewhere, and certain of its rolling stock and equipment. Upon the completion

> of the construction and/or acquisition of the Company's 'Northern California Extension' its main line of railroad will aggregate 1198.5 miles, more or less. A map of the Company's railroad system is hereto annexed."

It would have been simple to state definitely, and it would have been definitely stated if so intended, that "upon the completion of the Northern California Extension the First Mortgage will constitute a first lien thereon". The Refunding Mortgage, it will be recalled, does not describe the property covered thereby as being entirely subject to the First Mortgage, but states that its lien is "subject, however, in so far, but *only in so far* (in extent, degree of priority or otherwise), as in law the same respectively may attach to any part or parts of the trust estate * * *".

Limitations on after-acquired property clauses.

The after-acquired property clauses of the First Mortgage are so phrased as to subject only limited classes of property thereto. These classes are described in paragraph Third of the granting clauses (R. 122-24). They are expressly limited to:

(a) Properties "acquired or constructed by the use of First Mortgage bonds or proceeds thereof or cash deposited" thereunder, "or on account of the purchase, acquisition or construction" whereof First Mortgage bonds or proceeds or deposited cash were used;

(b) Property or facilities "constituting an integral part" of the mortgaged property;

(c) Property or facilities "used or acquired for use in or for the maintenance or operation of or appertaining to" the mortgaged property;

(d) Certain securities or properties of specified "subsidiary" companies.

The free funds paragraph, already mentioned in Point II (see page 18, *supra*), includes a right "to construct or acquire *free from the lien hereof* lines of railroad, extensions or branches or interests therein" provided they do not fall in any of the four classes which were described in paragraph Third above mentioned.

Argument

In view of the absence of any supplemental indenture or other recorded instrument expressly subjecting the Northern California Extension to the lien of the First Mortgage, the only basis for the First Mortgage Trustees' claim of lien thereon must be that the after-acquired property clause of the First Mortgage compels such a result.

Any claim of the First Mortgage Trustees to the Northern California Extension must be based on clause (a), relating to the use of First Mortgage bonds or proceeds in the construction or acquisition thereof. The other clauses may be ruled out at the outset.

Clause (b), relating to property "constituting an integral part" of the mortgaged property, is obviously of extremely narrow effect, and cannot cover a new branch extending one hundred miles from the main line. Certainly it cannot have a broader meaning in this connection than the succeeding appurtenance clause (Clause (c)).

Clause (c), relating to property "appertaining to the mortgaged premises", also has a very limited application. It cannot cover other real estate or branches.

In *New Orleans Pacific Railway Co.* v. *Parker*, 143 U. S. 42, 55, the Court said:

> "Property, however, not connected with what is ordinarily termed the plant, or not forming a part of the organic structure of the road, is never treated as appurtenant to it."

See also *Humphreys* v. *McKissock*, 140 U. S. 304, 313-14, where the Court said:

"A thing is appurtenant to something else only when it stands in the relation of an incident to a principal, and is necessarily connected with the use and enjoyment of the latter. *Harris* v. *Elliott*, 10 Pet. 25, 54; *Jackson* v. *Hathaway*, 15 Johns. 447, 455; *Linthicum* v. *Ray*, 9 Wall. 241. Of two parcels of land one can never be appurtenant to the other."

* * * * * * *

"Under the term 'appurtenances,' as used in the mortgage in question, only such property passes as is indispensable to the use and enjoyment of the franchises of the company. It does not include property acquired simply because it may prove useful to the company and facilitate the discharge of its business. A distinction is made in such cases between what is indispensable to the operation of a railway and what would be only convenient. *Bank* v. *Tennessee*, 104 U. S. 493, 496."

The same principle of construction was applied in *Great Northern Railroad Co.* v. *Central Hanover Bank and Trust Co.*, 12 F. Supp. 846 (W. D. Wash.), and *Old Colony Trust Co.* v. *Standard Beet Sugar Co.*, 150 Fed. 677 (N. D. Neb.).

Clause (c) also refers to property "for use in or for the maintenance or operation of" the mortgaged property. This cannot apply to the Extension, for such a covenant is restricted in application to property strictly necessary for such maintenance or operation. *New Orleans Pacific Railway Co.* v. *Parker*, 143 U. S. 42, 54-57.

There is no equitable basis for giving the First Mortgage a lien on the Extension beyond the amount which it contributed towards its construction.

From the foregoing rules, it follows that the First Mortgage Trustees cannot claim a lien on any portions of the Northern California Extension which were not acquired with the proceeds of their bonds. Since they have shown no evidence as to the portions of the Extension on which

their money was used, it is only fair that their lien be restricted to the proportion which the $5,000,000 of First Mortgage Bonds issued for the Extension bear to the total cost of over $10,000,000.

Under the provisions of the First Mortgage there could be no question that, if First Mortgage money had been applied to the acquisition and construction of the Extension northwardly from its beginning at Keddie until it was exhausted, and money from other sources then applied to the acquisition and construction of the remainder of the line, the northerly portion would be free from the lien of the First Mortgage and subject to the Refunding Mortgage. The proof does not indicate whether this took place or whether funds from all sources were spent indiscriminately over the whole mileage.

In a court of equity, which looks to substance rather than form, it should be of no consequence which method was used or who has the burden of proof—although it is conceded that the burden is on the First Mortgage Trustees. A court of equity should decree either that the First Mortgage is a first lien on a portion of the total Extension mileage equal to the proportion that its contribution bears to the total cost, or that it has a first lien on an undivided interest in the whole Extension in the same proportion, and that the Refunding Mortgage has a first lien on the remaining undivided interest.

Equitable principles are the only basis for enforcing after-acquired property clauses at all (*Pennock* v. *Coe*, 23 How. 117), since a mortgage cannot create a legal lien on non-existent property. Substantially this view of after-acquired property clauses is upheld in the California decision of *Bibend* v. *L. & L. F. & L. Insurance Co.*, 30 Calif. 78, 86, quoted in *Mason* v. *Citizens National Trust and Savings Bank*, 71 F. (2d) 246 (C. C. A. 9), which discusses the general rule that assignments of things having no present actual existence are not recognized at law, but are given effect only by courts of equity.

Equitable treatment of the Refunding Mortgage creditors, who supplied the major portion of the money necessary to place the Extension in operation, is required also by the provisions of Section 77, which authorizes creditors affected by a plan to file their "claims for equitable treatment" (Section 77(e)).

Moreover, after-acquired property clauses, as set forth in Point II (pp. 20-21), are strictly construed, and enforced only to the extent that their terms "imperatively demand".

Within these rules the First Mortgage Trustees have failed to prove that the entire Extension ever became subject to their entire mortgage as a first lien.

There is no unfairness to the First Mortgage Bondholders in limiting their lien to $5,000,000. All that they contributed to the construction of the line was $5,000,000. All that their mortgage entitled them to in respect of property financed with First Mortgage funds was dollar for dollar value, that is, $5,000,000 of new property for $5,000,000 of First Mortgage money. In seeking to obtain the entire $10,000,000 value of the Northern California Extension for a $5,000,000 investment, and to make the Refunding Mortgage creditors junior in lien on the Extension to the $45,000,000 of First Mortgage bonds which were outstanding before the Extension was built, the First Mortgage bondholders are demanding a gift at the expense of the creditors whose money made possible the completion of the Extension.

The position of the First Mortgage Trustees and bondholders is that since part of the cost of the Extension was financed with First Mortgage money the entire Extension comes under the entire lien of their mortgage. No limits to this contention are, or could be, suggested. It would make the whole $10,000,000 Extension subject to the entire mortgage if only the most trivial amount of First Mortgage moneys were used thereon. The First Mortgage Committee even argued in the Circuit Court of Appeals that they were entitled to a $50,000,000 lien on the Extension if "one penny" of First Mortgage money were spent thereon (Brief in C. C. A., p. 60)—a result which would be in the highest

degree inequitable. The language of the First Mortgage does not require any such inequitable result, and courts will always refrain from adopting a construction which works injustice if another one is available. *Graselli Chemical Co.* v. *Aetna Explosives Co.*, 252 Fed. 456, 459-60 (C. C. A. 2d); *Pavlowski* v. *Mohawk Golf Club*, 204 App. Div. (N. Y.) 200, 204; 198 N. Y. Supp. 30, 34; *Restatement of Contracts*, Section 236(a).

The only possible method of imposing equitable limits upon the theory that the First Mortgage Trustees advance is, as we suggest, to limit the lien of the First Mortgage to, or make it proportionate with, the amount of First Mortgage money used.

The decisions which the First Mortgage Trustees have heretofore cited, and will doubtless cite in this Court, in opposition to the existence of any lien for Refunding Mortgage creditors, all involve a question of a claimed exclusive prior lien—that is, an effort entirely to displace a first mortgage. That is not what we seek in this case at all. The Refunding Mortgage Trustee's position is that, in arriving at an equitable distribution of the new securities, the creditors whose money made possible the completion of a line which is worth much more than the amount of First Mortgage money spent thereon, are entitled to receive securities of a higher rank than common stock in recognition of the very real contribution which they have made to the system. Even if the Refunding Mortgage creditors were to be treated as having only a second lien, subject to $5,000,000 of First Mortgage bonds, upon the Northern California Extension, they would be entitled to receive new income mortgage bonds and new preferred stock in recognition of this second lien. However, their lien is entitled to equal rank with that of the First Mortgage bondholders.

Although few decisions have been found which involve a similar situation, equity will not be precluded from granting proper relief even though the circumstances may be unusual. *Graselli Chemical Co.* v. *Aetna Explosives Co.*, *supra.*

The right to a coordinate or *pari passu* lien was recognized in the well considered case of *Citizens Savings and Trust Co.* v. *First Cincinnati & Dayton Traction Co.*, 106 Ohio St. 577; 140 N. E. 380. In that case three companies had made mortgages each containing after-acquired property clauses. These companies were later consolidated to form the Southern Ohio Traction Corporation which, of course, acquired the property subject to all existing liens. The new corporation made a mortgage on the consolidated property, covering properties received from the three underlying companies and also other properties. The three underlying companies had each owned a separate power plant and transmission lines. Upon consolidation it was decided to discontinue the separate power plants and build a general power plant to furnish energy for the operation of the entire consolidated system. The Court held that the three underlying mortgages were entitled to liens of equal rank upon the central power plant in proportion to the power requirements of each.

This result is almost identical in substance with what we have suggested with respect to the Northern California Extension. First Mortgage creditors and Refunding Mortgage creditors have both contributed to its construction. Neither can claim that it could have been completed without the contribution of the other. Both should be held entitled to liens of equal rank thereon.

In the present case the equities are even stronger than in the *Cincinnati & Dayton* case, for the creditors secured by the Refunding Mortgage bonds contributed actual new money, which was certainly a more valuable contribution than the old individual power plants which were contributed to the common enterprise in the *Cincinnati & Dayton* case.

In *Guaranty Trust Co. of New York* v. *Minneapolis & St. L. R. Co.*, 36 F. (2d) 747 (C. C. A. 8), the Court went so far in protecting a later mortgage as to hold that it was the first lien upon a bridge described therein, although an earlier mortgage covered one line terminating on the east-

erly bank of the river and another line terminating on the westerly bank—between which lines the bridge was the only connection.

The Plan fails to give equitable treatment to the Refunding Mortgage creditors insofar as it refuses to accord them any securities senior to common stock in recognition of their lien on the Northern California Extension.

V

The Refunding Mortgage creditors are entitled to additional securities in recognition of their interests in free assets of the Debtor.

Facts

The items of non-carrier real estate which are in dispute herein are valued on the Debtor's books at over $1,850,000. The major item consists of acreage in the Islais Creek district of San Francisco (R. 1090), which is described in the printed record. The other items, together with certain facts respecting each, are listed on an exhibit (Ex. H to the Stipulation of Facts Not in Dispute) which is not printed as part of the record.

Portions of such non-carrier real estate have been sold from time to time during the course of the reorganization proceedings, and the proceeds deposited in escrow pending determination of the lien thereon. Up to December 20, 1939, the total of such proceeds amounted to over $204,000 (R. 1093-94).

The Islais Creek property is a tract of land and land under water bordering on San Francisco Bay, which was acquired by Debtor's predecessor in the hope that it could be developed into a great industrial center, which might produce traffic for the Debtor (R. 2528). When the Commission, in 1929, valued the Western Pacific property pursuant to Section 19-a of the Interstate Commerce Act, it

ruled, after analyzing the history of the property and acquisition, that the Islais Creek tract was not carrier property (Ex. 104, p. 276):

> "It thus appears that these lands were not used for common carrier purposes on June 30, 1914, and that their use for such purpose cannot be said to have been imminent."

The present First Mortgage bonds were issued pursuant to a reorganization plan in 1915, which contemplated that they should be a lien only upon "*railway properties*". The 1915 plan, in describing the new issues, states as follows:

> "First Mortgage Gold Bonds (the new bonds) Authorized Issue $50,000,000.
>
> To be secured by First Mortgage upon all of the *existing railway properties* of the old company and all property hereafter acquired by the operating company *integrally connected therewith* and all property *acquired by means of the use of the proceeds of the new bonds* or against which new bonds shall be issued" (R. 1141).

The properties in dispute were not integrally connected with the Debtor's railway property, and were not acquired from proceeds of First Mortgage bonds. In fact, an examination of the schedule of uncapitalized expenditures (Ex. 31) reveals that no part of the moneys used for payment of benefit assessments or other expenditures in connection with the Islais Creek properties was ever made the subject of withdrawal of First Mortgage moneys.

The Islais Creek property was originally included in account 701 on the Debtor's books, entitled "Investment in Road and Equipment", and was transferred in 1935 to the account entitled "Miscellaneous Physical Property" (R. 1090).

Argument

Although there is some language in the First Mortgage which may be broad enough to cover pre-existing non-carrier real estate, the Mortgage must be read in the light of the 1915 reorganization plan, which constituted a contract between the stockholders of the Debtor (who were bondholders of the predecessor company) and the new First Mortgage bondholders, as was expressly ruled in the case of *American Brake Shoe and Foundry Company* v. *New York Railways Co.*, 277 Fed. 261, 271-72 (S. D. N. Y.). See also

Safety Car Heating & Light Co. v. *U. S. Light & Heating Co.*, 2 F. (2d) 384, 388 (W. D. N. Y.);
Harris Trust & Savings Bank v. *Chicago Railways Co.*, 56 F. (2d) 942, 947 (C. C. A. 7).

Any interpretation of the First Mortgage as granting a lien on property in excess of the lien provided under the 1915 reorganization plan would violate the terms under which the old bondholders agreed to take stock in the new company (the Debtor herein) in exchange for their claims.

Moreover, the First Mortgage contains no description of the Islais Creek real estate or the other non-carrier real estate then owned. *Property of the size and importance of the Islais Creek real estate would certainly have been included in the First Mortgage by specific description if it had been intended to cover it thereby.* An interpretation of the general language in the First Mortgage with respect to the mortgaging of lands, etc., "whether or not for use in connection with the railroad" (R. 1217-18) as covering this property would be inconsistent with the later provision of the First Mortgage by which the lien upon land is limited to such thereof as is appurtenant to the railroad lines (R. 1226).

The attempt by the First Mortgage Trustees to impose a lien upon non-carrier real estate is also met by the rule

that non-carrier real estate owned at the date of a railroad mortgage will not be considered subject to the lien thereof unless expressly described.

Alabama v. *Montague*, 117 U. S. 602, 609;
New Orleans Pacific Railway Co. v. *Parker*, 143 U. S. 42;
Pardee v. *Aldridge*, 189 U. S. 429;
Seymour v. *Tonawanda & Niagara Falls R. R. Co.*, 25 Barb. (N. Y.) 284, 312;
Calhoun v. *Memphis & P. R. Co.*, 4 Fed. Cas. No. 2309, page 1047 (C. C. W. D. Tenn.);
Boston & New York Air Line R. R. Co. v. *Coffin*, 50 Conn. 150, 153;
State v. *Gleen*, 18 Nev. 34, 48; 1 Pac. 186, 193-94;
Shirley v. *Waco Tap Railway Co.*, 78 Texas 131, 146; 10 S. W. 543, 550, 551;
National Bank of Commerce v. *Lock*, 17 Washington 528, 532-33; 50 Pac. 478, 480.

The fact that items of non-carrier real estate were listed until comparatively recent years on the railroad's books under the account "Investment in Road and Equipment" carries no inference as to their nature or as to whether they were subject to the First Mortgage, and in any event could not alter their character or create a lien on them which the reorganization plan forbade and the First Mortgage did not impose.

It requires much more definite language than anything the First Mortgage Trustees can point to in order to bring these substantial parcels of real estate under its lien.

The necessity of recognizing the rights of creditors in unmortgaged assets was pointed out by this Court in *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, where it was held that bondholders of a subsidiary would have, to the extent that they were general creditors of the parent company, "prior recourse against any unmortgaged assets" of the parent company, under the rule of absolute

priority laid down in the cases of *Northern Pacific R. Co.* v. *Boyd*, 228 U. S. 482 and *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106.

The distribution of any new securities granted in lieu of the free assets should depend on the rights of the various parties as general creditors; that is, for any difference between the total debt and the value of their security the First Mortgage creditors and the Refunding Mortgage creditors would share in these assets with Western Pacific Railroad Corporation (or Railroad Credit Corporation, as pledgee of the latter's claim) and Western Realty Company.

There has been no precise determination of the amount of the assets subject to the payment of the respective claims or of the extent of the deficiency of mortgaged assets to pay the mortgage debt. However, a practicable and equitable method for such determination here would be to base the participation of the secured creditors on the difference between the total amount of their claims and the par value of income bonds and preferred stock otherwise issuable to each—the exact figures being subject to computation after the other objections to the Plan have been determined.

CONCLUSION

1. The issues relating to the extent of the Refunding Mortgage lien must be determined before the reorganization plan is sent back to the Commission.

2. This Court should adjudge that the Refunding Mortgage constitutes a first lien on the equipment-trust rolling stock and a first lien to the extent of $5,000,000 (subject to a *pari passu* first lien of $5,000,000 by the First Mortgage) upon the Northern California Extension.

3. The non-carrier real estate, and the cash proceeds, now held in escrow, of non-carrier real estate which has been sold during the reorganization proceedings, should be decreed to be free from the lien of the First Mortgage.

4. The Commission should be instructed, in passing upon any substitute plan of reorganization, to give due recognition to the lien of the Refunding Mortgage upon the equipment-trust rolling stock and the Northern California Extension, and should also be instructed to fix the value of the Central California Traction and Alameda Belt Line securities, on which the Refunding Mortgage is admittedly a first lien, and give recognition to such value in the allocation of new securities.

The decrees of the Circuit Court of Appeals should be modified in accordance with the foregoing brief, and the proceeding referred back to the Interstate Commerce Commission for appropriate modification of the reorganization plan.

New York, September 14, 1942.

Respectfully submitted,

H. C. McCOLLOM,
Attorney for Petitioner,
IRVING TRUST COMPANY, as
Trustee under Debtor's
Refunding Mortgage.

ORRIN G. JUDD,
Of Counsel.